

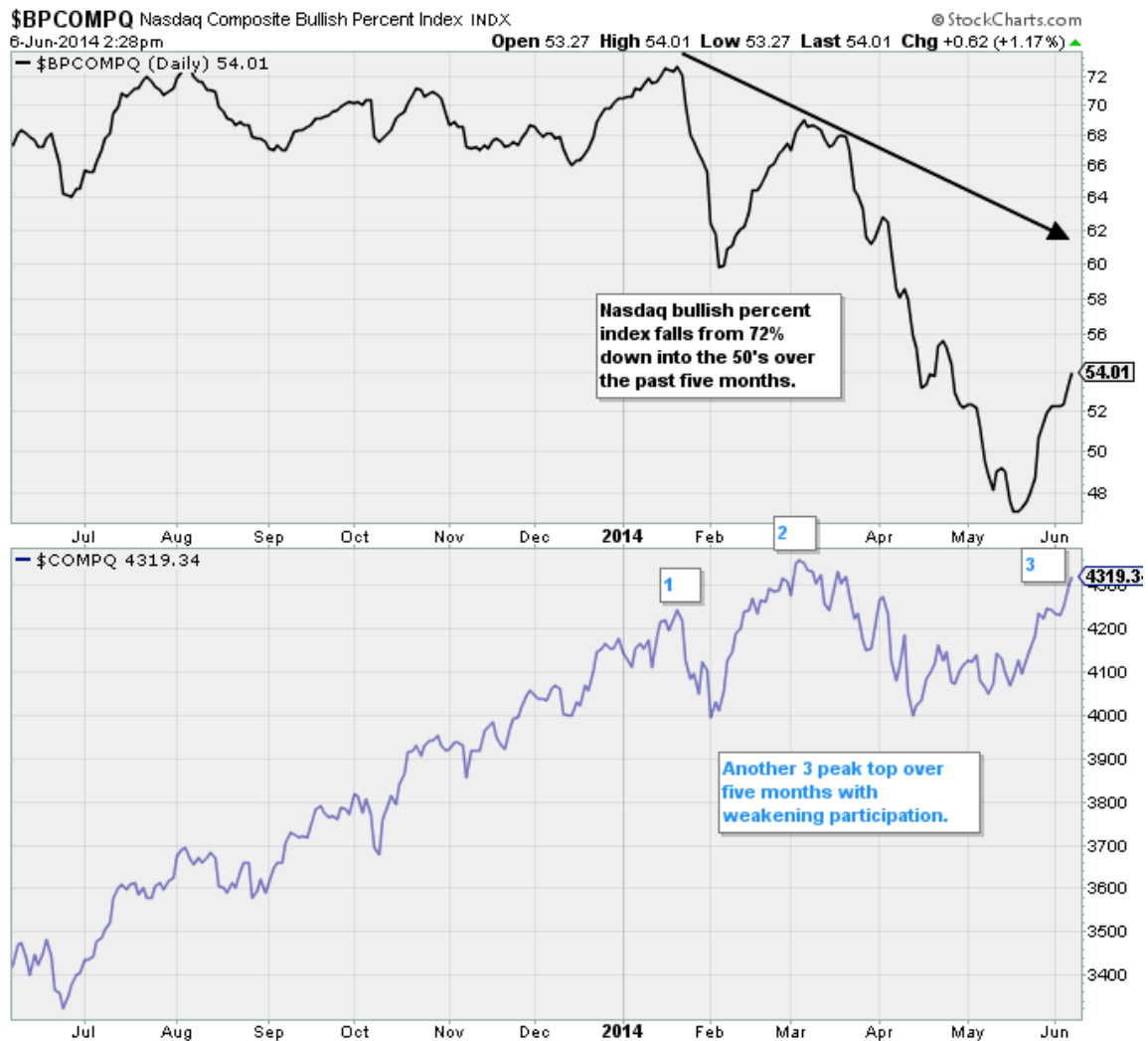


The Starboard Side Report

The week ending June 6, 2014

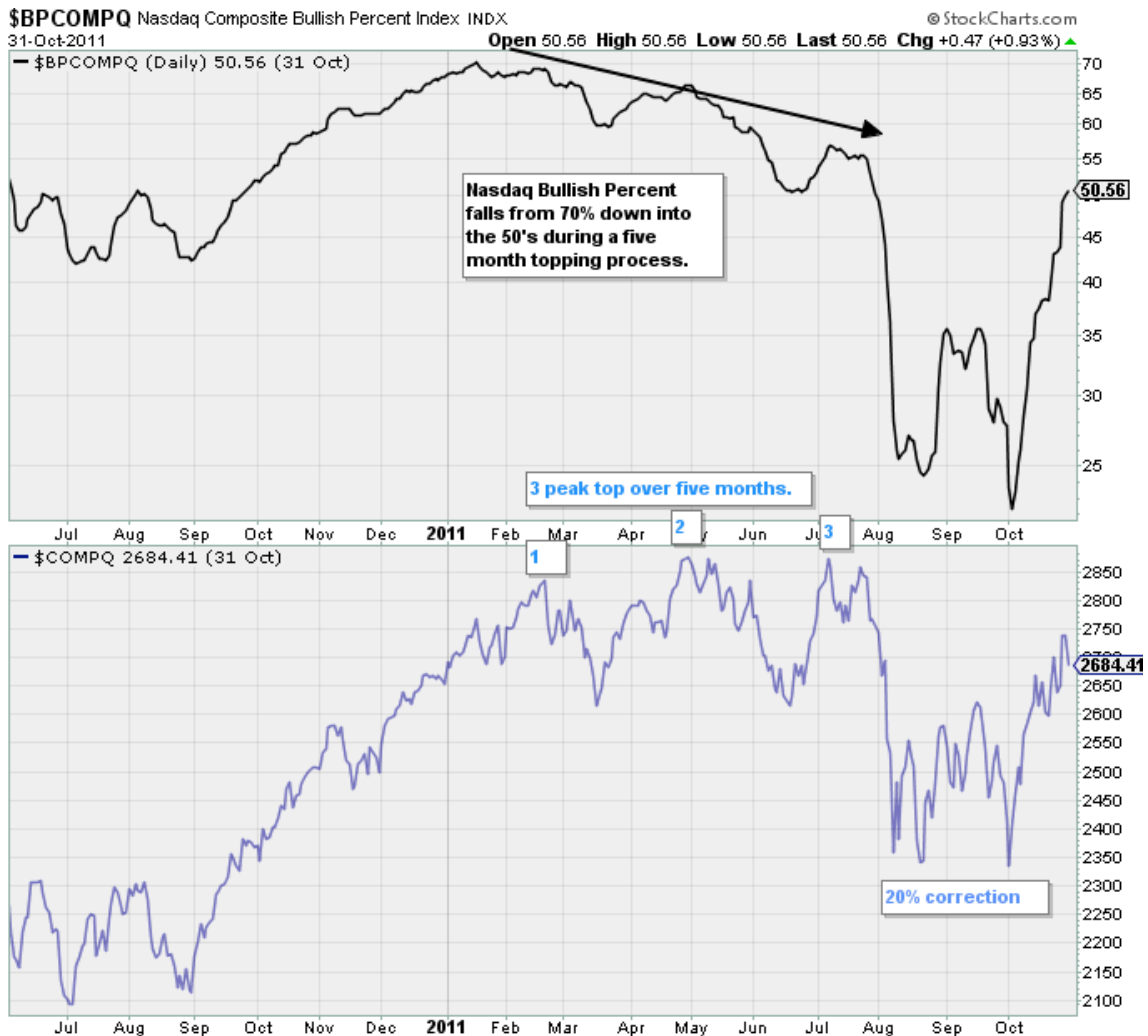
Those that read this report with regularity know that we are very keen on studying the markets for key *divergences* that may indicate the exhaustion of a trend and a major tactical pivot on the part of smart money investors. Last week we showed a positive divergence that is pointing to a bottoming for the beleaguered gold mining stocks. Even though the index of gold miners is about at the same price level as it was one year ago, the number of stocks that are on buy signals is dramatically higher. This type of increased participation is what one wants to see during a bottoming phase. This week we wanted to focus on the opposite end of the spectrum to show a major *negative* divergence that is taking place in the Nasdaq Composite Index and how it looks exactly the same as the negative divergence in 2011 (not coincidentally when the QE2 stimulus program was being withdrawn). The chart on the top is the Bullish Percent Index of the Nasdaq Composite and the underneath frame is the price chart of the Nasdaq Index itself.

2014 NASDAQ Divergence



The important take away is that, even though the Nasdaq is back to within a whisker of its cycle highs, the number of stocks on buy signals in the index has plunged to only 54%, down from 72% at the beginning of the year. That means there have been fewer and fewer stocks holding up the index each time it has gotten back to these lofty levels. We have identified the three peak topping process on the Nasdaq chart (with the numbers 1, 2 & 3) in order to show the uncanny similarity to 2011 in the next chart.

2011 NASDAQ Divergence



You can see that there was a five-month topping process (with 3 peaks) that is equivalent to the move we have seen over the past five months of 2014. Most importantly, we can also clearly observe that the Nasdaq Bullish Percent Index fell from 70% to 55% as the market was making a token new high in July 2011 (peak 3). Again, weakening market “internals” are a major red flag that many investors chose to ignore because the headlines (that are focused on the new index highs) trump what is going on under the surface. Those that heeded this warning from the Bullish Percent Index in 2011 when the Federal Reserve was tightening liquidity were spared a 20% correction in the general market and a much sharper drawdown in many individual stocks.

We can file this next segment in the “it doesn’t matter until it does” bin. That seems to be the case with all of the “top down” valuation charts that we have been showing lately. However, that does not mean we are going to stop focusing on them. Abandoning an investment discipline on the whims of the crowd is a terrible long-term strategy. This week we are going to check in on the US Stock Market Capitalization to GDP ratio to see where it stands. Doug Short of *Advisor Perspectives* refers to this as the “Buffett Indicator” because back in 2001 Warren Buffett declared it the best single measure of where valuations stand at any given moment. To get this ratio we can simply divide the Wilshire 5000 Full Cap Price Index by US GDP.

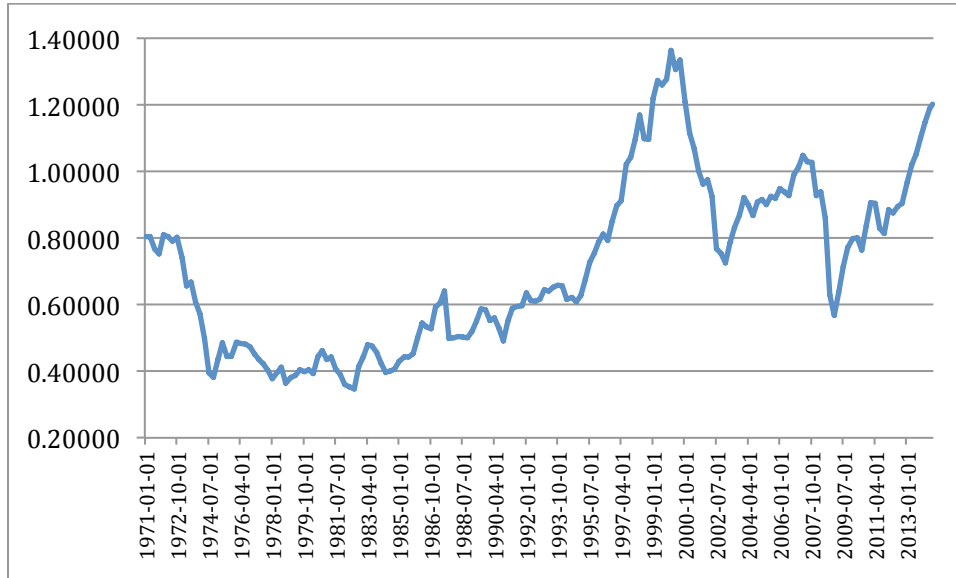
First we wanted to show a chart of the raw price of the Wilshire 5000 Fully Capitalized Price Index that serves as the numerator in the equation. The price level of this broad index serves as a representation of the total market capitalization of the US stock market (without dividends reinvested). As we can see below, the present the level of this index is at 20,577; which means the US stock market is worth roughly \$20.57 trillion as of June 6th.

Wilshire 5000 Full Cap Price Index (1970 – Present)



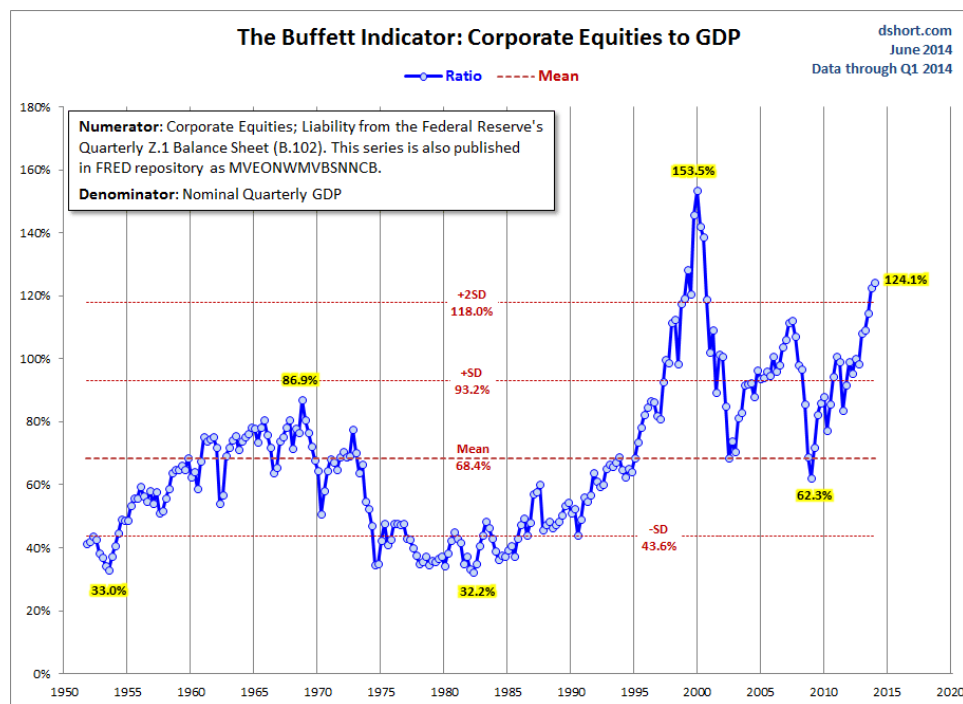
Next we use US GDP of \$17.10 trillion as our denominator to get our current ratio of just over 1.2 (meaning the stock market’s value is 20% greater than the value of the economy). In isolation this ratio may not mean much, but we believe that its true value is seeing where it stands versus history. As such, we have plotted the data going back to 1970 in the chart below. The data shows that bear markets have historically ended with the stock market at 1/3 the size of the economy! That is a long way below where we stand today.

Total Value of US Equity Market (Wilshire 5000 Full Cap Index) vs. US GDP



As you can see, the 1999 and early 2000 period (during the terminal phase of the great stock bubble) was the only time in the past 45 years that the market was this richly valued. Doug Short was able to get information from the Federal Reserve that goes back even longer (using the value of corporate equities from the Fed and not the Wilshire 5000 in the numerator). This paints the same picture of an extremely overvalued US market. If you are betting on the US market here, you are betting on a rapid acceleration of economic growth. The fact GDP actually **contracted** at a rate of 1% in the first quarter of 2014 does not lend much credence to this bullish outcome.

Corporate Equities to GDP Ratio (1950 – Present)

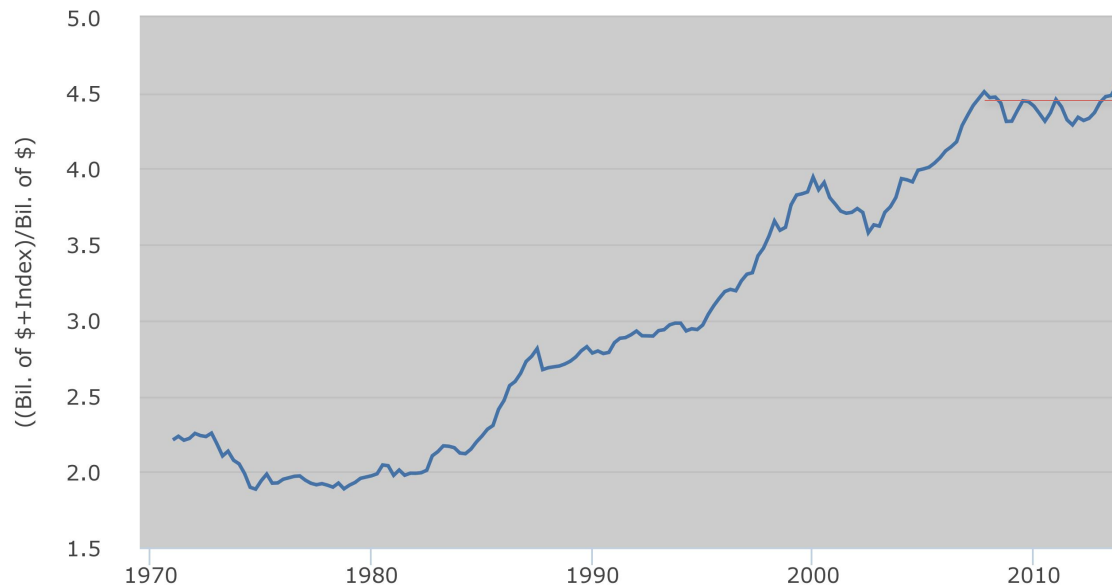


The final chart we have put together shows why we think the current situation is even more dangerous than the 1999 – 2000 top. Contrary to popular belief that the “system” has healed itself after the financial crisis, this chart shows financial assets still in runaway bubble territory when compared to the underlying economy.

Credit Market Debt Outstanding plus Total US Equity Market Value to GDP Ratio

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— (All Sectors; Credit Market Instruments; Liability, Level+Wilshire 5000 Full Cap Price Index©)/Gross Domestic Product



2014 research.stlouisfed.org

In the 1970's and early 1980's, the combined total value of credit market debt and corporate equities gravitated around 2.0 times the size of the economy. Today at almost 4.7 times, we are actually 20% beyond the 2000 top and now breaking back above the peak of the real estate bubble in 2007! Ultimately, what this picture shows is that there are still too many financial claims on the underlying capacity of the economy and that there has been no real deleveraging or discovery of financial religion. This overcapacity is still the most readily apparent within the bloated financial sector that the Federal Reserve insists on propping-up. We feel that this central planned scheme of runaway asset inflation that has built up over the past two decades has to be resolved via a final massive debt deflation or by way of a massive multi-year wave of double-digit consumer price inflation (and further currency debasement). It is our belief that portfolios should be carefully risk managed in both directions in order to mitigate the wealth destruction that *either* of these outcomes will ultimately deliver to those unprepared.

The bottom line is that our comprehensive analysis of the current market climate continues to point to a market with *much* more downside risk than upside potential.

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Please note: It is the Client's responsibility to notify us of any changes that would influence their financial needs.